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Financial Reporting? — It Simply Doesn't Work

Views on 'Corporate Reporting Revisited' by J. Hegarty, C. Beckers and E. De Keuleneer

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I. INTRODUCTION

In this text, Prof. Willekens reports on the reflections proffered by the chair (John Hegarty) and two of the guest speakers (Stan Beckers and Eric De Keuleneer) at the occasion of the second seminar, 2000-2001, of the PwC Chair *Value and Risk.* The seminar took place on February 22, 2001, and its financial theme was *Value and Risk: Corporate Reporting Revisited.* As the title of the present report suggests, the consensus was not undividedly in favor of reporting as it stands now.

II. BAD INFORMATION LEADS TO BAD VALUATION

To John Hegarty, it is obvious that financial reporting does matter. This is not a surprising view, perhaps, for a former Secretary General of the *Féderation des Experts Comptables Européens* (FEE). But also in his new role of World bank officer, financial reporting remains crucial. Reporting is the basis for proper valuation, which then allows one to weigh policy alternatives, essential in the WB's fight against poverty. Yet, for all its importance, in practice financial reporting simply does not work. Financial reporting fails miserably because its three essential ingredients — recognition, measurement and disclosure — no longer work. What is being reported is still largely historic-cost based, which is per definition as backward looking as can be. True, Fair Value Reporting is gaining in importance; but even Fair Value Reporting remains too much focused on past decisions, and therefore still entirely misses the input that is crucial for valuation purposes, the company's prospects for the future.

As balance sheets do not provide the true answer, investors turn to alternative sources of information (like audit reports, but especially analysts' reports and press coverage, discussed critically by Stan Beckers and Eric De Keuleneer, as reported below). There are big issues of reliability and interpretability here, as again amplified below. The result of this un-informed and informal valuation process is a wide divergence between reported historic value (or, in some cases, replacement value) on the one hand, and market value on the other. Worse, the resulting market values often seem to be unsustainable and unstable. We recently saw, for instance, plummeting ICT values without any change whatsoever in the underlying fundamentals. Such volatility in stock market valuations may lead to instability in financial systems and to systemic risk. The true victims of such financial crises are not so much the richer, Western investors: these only lose (some of) their shirts and then typically bounce back rapidly. Rather, the worst off are the poor of this world, where financial catastrophes too often lead to a collapse of school attendance and a disruption of health system and where, therefore, bounce-back is a matter of a generation rather than a few years.

In the above, one cause of the observed instability in valuation is deemed to be the failure of financial reporting — the outward flow of information generated and steered by insiders. Yet it is by no means clear that markets, when provided with the right information, would actually do the valuation process correctly and efficiently. The second and equally important issue, next to the quality of the information production, indeed is how valuation is arrived at by these very outsiders. Still, the natural focus of our reflections, at this seminar, is the inside-out part, financial reporting. And conundrum is that it may not really be possible to provide the right information at all. This is the first of the many issues about the future that were raised by Mr Hegarty.

III. QUESTIONS FOR FUTURE REPORTING

The value of a corporation is increasingly based on a nexus of contacts and contracts. But these contracts are not enforceable, are not separable, and have no clear owner. In a services firm, who is the owner of the customer relations: the company, or the employees? How can we make sure that crucial assets do not walk away, or that key employees do not walk away with vital intangible assets? How, then, can one report these assets' values? Also, the risks and uncertainties are very different to different stakeholders, even if we confine ourselves to purely financial stakeholders. When companies get close to financial distress, for instance, one often sees heftier reactions in bond prices than in stock values. One reason is that these two types of financial claims, even though both are contingent on the same underlying assets, are nevertheless quite different derivatives. A second reason is that information relevant to bondholders, like the true current value of individual assets pledged as security to certain bonds, is not always made available on a regular basis. In light of this, it is still tenable to claim that one type of report — the one aimed at the shareholders — also provides all the information needed by other interested parties? Thus, the question becomes: who are the users of information, and what are their needs? Don't we need flexibility here rather than a standardized, centrally regulated process? And how do we square this need for flexibility with the need for rules that guarantee a certain degree of reliability? For instance, as Stan Beckers amplifies in his remarks reported below, there have been flagrant examples of earning management, recently. But a related issue is the one of *pro forma* profit and loss statements, as used in contacts with investors: unlike regular financial reports, these forward-looking statements are entirely unaudited and unstandardized. Is this the type of flexibility the market(s) need?

There are other issues. First, with new (electronic) channels of communication coming on stream, should financial reporting not become a continuous process rather than the discrete, once-a-quarter (or not that long ago, once-a-year) one? Perhaps, when the flow of information has become continuous, one would witness less of the nervousness and alleged overreaction that surrounds the current quarterly earnings releases. Second, should auditing still be focusing on the financial reports themselves? Shouldn't the attention be directed towards the reporting and information systems behind those reports? Third, who should regulate the reporting activities? Is the traditional, central regulator still the model for the future? Or, if reporting becomes much more differentiated across industries and/or investor classes, who is overseeing the overseers, and who is accountable to whom? Lastly, bear in mind that an unresolved issue still is whether the defects in the market's valuation are mostly based on failures in the "inside-out" information process, rather then in the "outside-in" process of how third parties arrive at values about the firm's prospects. This is, John Hegarty concludes, the user of financial information has to do a good job too.

The guest speakers that comment or expand on John Hegarty's introductory statements are, not coincidentally, two such users of financial information: Stan Beckers, representing the large, institutional investor, and Eric de Keuleneer, a well-known champion for the rights of the small investors. In his address, Stan Beckers very much agrees that financial reporting does not work. Yet, as Chief Investment Officer overseeing the management of 40b USD, he sorely needs good information. Whence this failure? Prof. Beckers develops his argument in four steps.

IV. INFORMATION IS INCREASINGLY (*i*) IRRELEVANT AND (*ii*) UNRELIABLE

The first observation is that accounting is still rooted in the old industrial era, where value was very much tied in with tangible assets like plant & equipment, work in process, or receivables. Right now, however, value resides far more in the firm's intangibles: know-how and knowledge, R&D, customer satisfaction, and so on, which are hard to value (as we just saw). Thus, investors get less relevant information than before. As a result, they go for types of information other than reported asset values, like revenues, sales, and earnings, to which they attach great value. And "great value" is to be read not just as great importance, but also as big multiples. Market-to-book, for instance, is now of the order of 6 rather than the numbers of the order of 2 that we used to see two decades ago.

In view of such multiples, any surprise in earnings (or sales etc.) has a hefty impact on value. This hypersensitivity of market value, then — step two, in Stan Beckers' argument — creates incentives for management to "massage" earnings. Thus, information is not only less relevant than before: it is also less reliable or accurate. Examples of manipulation or outright fraud abound, recently: Lucent, Xerox, Waste Management, and (closer at home) Lernout & Hauspie were just some of the more conspicuous ones.

V. ...AND THE OVERSEERS, PRIVATE OR PUBLIC, DO NOT REALLY WORK EITHER

These instances of earnings management are, of course, also instances of audit failures. This, then, brings us to the third problem. Whereas traditionally the Big8 (or 6 or 5) accounting firms made two thirds of their money from auditing activities, this source of revenue has now dwindled to less than one-third of total income. Such an evolution raises doubts about auditor independence — hence the SEC's plans (implemented, in the meanwhile) to force auditors to divulge, in the audit reports, their non-auditing income derived from the auditee. One even hears it voiced that, right now, auditing has become a mere loss-leader, an entry to the business that auditing firms are *really* after.

In the US, the SEC does try to curtail potential abuses in the auditing business. The SEC has also dealt harshly with cases of earning management and audit failures. For instance, three executives of Micro Strategies were recently ordered to (personally!) pay fines and damages of no less than USD 11b for abuses in reporting. The SEC also issued, recently, a level-playing-field rule that prevents corporations from favoring (and, some say, controlling) financial analysts: all news must now be released immediately and directly to the entire investing community. In Europe, however, we are facing Problem 4: there is no SEC-like institution that first and foremost protects the investors, or at least none with similar zeal and powers. Insider-dealing cases rarely make it to court, or fizzle out before the bench, or let guilty parties off rather lightly. Also the market for auditing is notoriously non-litigious, in Europe. Analysts are not independent commentators either: the porousness (or even entire absence) of Chinese Walls between investment banking (i.e. placement) and financial analysis prevents analysts from being critical about companies. Analysis provided by stock brokers is equally partial, aimed at generating turnover rather than information. In short, analysis by the sell side is inherently dubious.

VI. THE DIYS ALTERNATIVE

Facing financial reports that are increasingly irrelevant an inaccurate, and having no auditors nor overseers nor independent analysts to rely one, big investors have no choice to turn to buy-side analysis. Thus, Prof. Beckers reports, WLB has its own staff of analysts; and these behave increasingly like corporate detectives, looking for clues and signs and signals that may reveal more about the true state of affairs in the companies. Financial reports have become like swimsuits: the interesting bits behind them are the ones that remain covered, not the ones that are revealed.

VII. COMPANIES AND ANALYSTS FUDDLE...

Eric de Keuleneer appears to be on much the same wavelength. The problem is that the information provided by companies is hard to understand to the average investor. Thus, companies target analysts, and their main concern in this is that the information be pleasing to the analysts, not that it be relevant. Thus, we receive distorted information rather than fair reporting. For example, the firm's press release may stress a rise of return on equity following an acquisition, glossing over the details of how the consolidation with a low-growth firm is responsible for the rise rather than, for instance, greater internal efficiency or improved sales. Or the true cost of an acquisition may be covered up. Or mergers are presented as triumphs of synergistic common sense even when the true purpose is to eliminate a competitor — which, suprisingly then, regulators occasionally object to. Potential conflicts of interest are covered up, or poorly reported. In many reports the true cost of option plans, for instance, is hard to find out.

All this would not be a serious problem if financial analysts would be able and eager to read between the companies' lines and, in their own investment digests, let in the harsh light of reality into the firms' smoke-filled books. That is, however, too much to hope for. Analysts, in a disconcerting symbiosis with the corporations they follow, seem to be bent on pleasing their firms rather than producing information that is relevant to the ultimate investor. Their language is "coded". Analysts say "strong buy" when they mean "not bad at all", or say "buy" when they are agnostic. "Accumulate" really means "sell", and "hold" signals a recommendation to dump asap. A "sell" recommendation reflects imminent corporate demise. A SEC survey reported that, at the peak of the 2000 market, with prices at all-time-high multiples, only two percent of the recommendations were "sell"; eighty percent were "buy" or "strong buy".

Thus, analysts are not independent of the firms they follow, for they depend on the latter for the information they need to cut-and-paste into their own reports. Nor are analysts independent from their bosses, the investment bankers or market makers or stock brokers: Chinese-wall rules are absent, or not enforced. Nor are analysts critical and original: glassy-eyed, they all repeat the same received wisdoms and mantras: the only thing that matters is market share and website hits, consolidation is the only way forward, and first and foremost the modern investor wants a one-stop shop. In short, there is no primary research and no independent reflection.

VIII. ...AS DOES THE (LOCAL) PRESS

Fortunately, there is the press — if one lives in the US or the UK, that is. It was the Wall Street Journal, not a local newspaper, that raised eyebrows when a leading world-class innovator's South-Korean sales went from zip to one-third of world turnover in two years. Local reporters, like the local analysts, seemed blinded by feelings of national solidarity or adoration of the local supermen. There is no primary research and no independent reflection in the Belgian press either, Mr De Keuleneer concludes.

IV. ACCOUNTABLE?

All this raises an interesting question: wouldn't matters improve if analysts and the press became accountable for their deeds, or at least for the quality of their processes?